92-1186

No. ____

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

JOHN J. WATERS and JEANNE M. WATERS,

Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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QUESTION PRESENTED

Whether the Court of Appeals erred when it failed to consider the potential insolvency or bankruptcy of the taxpayer's lessee in determining whether the taxpayer was "protected against loss" within the meaning of section 465(b)(4) of the Internal Revenue Code with respect to the negotiable recourse promissory note he executed to purchase the computer equipment that he leased to the lessee.

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No. ____

IN THE

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JOHN J. WATERS and JEANNE M. WATERS,

Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITES STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

John J. Waters and Jeanne M. Waters respectfully petition for a writ of certiorari to review the decision of the United States Court of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The opinion of the Court of Appeals (App. 1a-19a), ____ F.2d ____, is unofficially reported at 1992-2 U.S.T.C. (CCH) ¶ 50,547. The opinion of the United States Tax Court (App. 20a-39a), T.C. Memo. 1991-462, is unofficially reported at 62 T.C.M. (CCH) 778.

JURISDICTION

The judgment of the Court of Appeals (App. 40a) was entered on October 21, 1992. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTE INVOLVED

A conflict among the Circuits exists with respect to the meaning of section 465(b)(4) of the Internal Revenue Code, 26 U.S.C. § 465(b)(4). Section 465 provides in pertinent part:

§ 465. Deductions limited to amount at risk

(a) Limitation to amount at risk.—

(1) In general.—In the case of—

(A) an individual

* * *

engaged in an activity tc which this section applies, any loss from such activity for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk (within the meaning of subsection (b)) for such activity at the close of the taxable year.

* * *

(b) Amounts considered at risk. —

(1) In general.—For purposes of this section, a taxpayer shall be considered at risk for an activity with respect to amounts including—

(A) the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity, and

(B) amounts borrowed with respect to such activity (as determined under paragraph (2)).

(2) **Borrowed amounts.**—For purposes of this section, a taxpayer shall be considered at risk with respect to amounts borrowed for use in an activity to the extent that he—

(A) is personally liable for the repayment of such amounts, or

(B) has pledged property, other than property used in such activity, as security for such borrowed amount (to the extent of the net fair market value of the taxpayer's interest in such property).

No property shall be taken into account as security if such property is directly or indirectly financed by indebtedness which is secured by property described in paragraph (1).

* * *

(4) **Exception.**—Notwithstanding any other provision of this section, a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

* * *

STATEMENT OF THE CASE

By this petition, the petitioners seek a determination by this Court of the legal test for whether a taxpayer is "at risk" for federal income tax purposes with respect to a negotiable recourse promissory note issued by the taxpayer to purchase equipment that the taxpayer then leases to an affiliate of the payee of the note. The Court of Appeals below applied its own business judgment to evaluate the business risks of the taxpayer's equipment leasing transaction instead of analyzing the rights and obligations of the parties to the transaction to determine whether the taxpayer would have been exposed to economic loss if the transaction had gone sour. The petitioners

contend that if a taxpayer is unconditionally liable on a note and does not have the benefit of any protective arrangement that will insulate him from loss if his lessee becomes insolvent or bankrupt, the taxpayer is "at risk." The fact that the taxpayer will not suffer any economic loss if the lessee remains solvent and makes all rent payments is not a basis for holding that the taxpayer is not "at risk."

This Court should resolve a conflict among the Circuits on this issue so that taxpayers are subject to consistent legal standards instead of the vagaries of the courts' business judgment.

1. *Material Facts*. Mr. and Mrs. Waters, husband and wife, filed joint federal income tax returns for 1982, 1983, 1984 and 1985. On those returns they claimed losses attributable to Mr. Waters' leasing of peripheral computer equipment to Equitable Financial Management, Inc. ("Equitable"). (App. 4a, 28a)

Equitable, a general equipment leasing company, had originally purchased the equipment from the manufacturer, ITT-Courier Terminal Systems, Inc., for $278,775. Equitable financed its purchase of the equipment by borrowing, on a non-recourse basis, from a bank. The bank loan was collateralized by a security interest in the equipment and by an assignment of the lease payments due under all end-user leases of the equipment. (App. 4a, 21a-22a)

Equitable leased the equipment to Duquesne Light Company ("Duquesne") for an initial term of five years and seven months. The lease payments essentially matched Equitable's payments on the bank loan. (App. 5a, 23a)

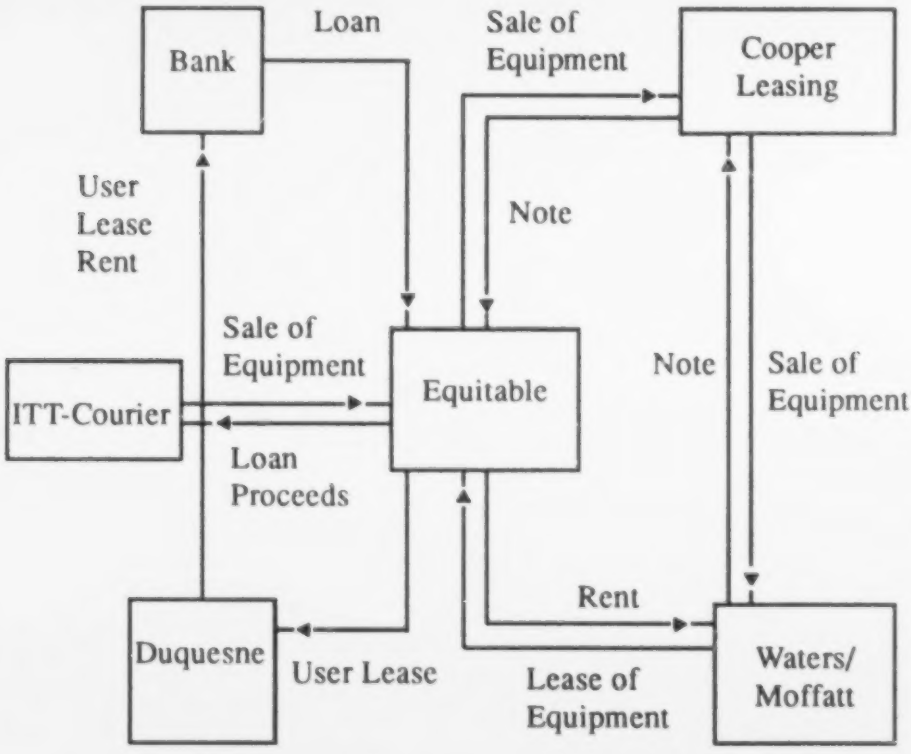
Equitable subsequently sold the equipment, subject to the Duquesne lease and the bank lien, to an affiliate, Cooper Leasing Corp. ("Cooper Leasing"), for $298,000. The purchase price was paid with a cash payment of $1,000 and a recourse promissory note in the amount of $297,000. In addition to monthly payments for eight years and four months, the note called for cash payments (designated as interest payments) in

the amounts of $10,000 upon execution, $26,643 six months later, and $27,720 one year after that. (App. 5a, 23a-24a)

Simultaneously with the sale of the equipment by Equitable to Cooper Leasing, Mr. Waters and Gerald A. Moffatt each purchased a fifty percent undivided interest in the equipment, subject to the Duquesne lease and the bank lien, from Cooper Leasing for $150,000. Each made a cash payment of $1,500 and executed a negotiable recourse promissory note in the amount of $148,500. (App. 6a, 25a)

Contemporaneously with their purchase of the equipment, Messrs. Waters and Moffatt leased the equipment to Equitable for a term of eight years and four months. The monthly rental payments due from Equitable under the lease essentially matched the monthly note payments due from Messrs. Waters and Moffatt to Cooper Leasing (and the monthly note payments due from Cooper Leasing to Equitable). In addition to monthly payments for eight years and four months, Messrs. Waters' and Moffatt's notes each called for cash payments (designated as interest payments) in the amounts of $5,000 upon execution, $13,322 six months later, and $13,860 one year after that. There were no rental payments under the lease corresponding to these interest payments. (App. 6a-7a, 25a-26a) Mr. Waters made all payments called for by his note. (App. 28a)

The following diagram outlines the structure of the transaction in which Mr. Waters participated:



The Commissioner of Internal Revenue (the "Commissioner") disallowed the losses attributable to Mr. Waters' computer equipment leasing activity. Mr. and Mrs. Waters petitioned the United States Tax Court for review of the Commissioner's disallowance.

2. *The Decisions Below.* The Tax Court held that, contrary to the Commissioner's determinations, (i) Mr. Waters' purchase and lease of the computer equipment "was not a sham transaction lacking in economic substance" (App. 37a); (ii) Mr. Waters had "an actual and honest profit objective for entering into the transaction" (*Id.*); and (iii) Mr. Waters "acquired ownership of the computer equipment" (App. 38a).

The Tax Court also concluded that Mr. Waters was not "at risk" with respect to the negotiable recourse promissory note he executed in connection with his purchase of the computer equipment because he was "protected against loss" within the meaning of section 465(b)(4) of the Internal Revenue Code. (App.30a) Mr. and Mrs. Waters appealed the "at risk" issue to the Court of Appeals. The Commissioner did not appeal the Tax Court's determinations in Mr. Waters' favor.

The Court of Appeals affirmed the decision of the Tax Court, ruling that for purposes of determining whether a taxpayer is "protected against loss," only "year-end economic realities" are to be considered. (App. 18a) Applying that standard, the Court of Appeals concluded that at the close of the tax years in issue, based on the cumulative effect of the underlying nonrecourse bank debt, the matching lease and note payment obligations, and a standard lessee indemnity contained in the Equitable lease, Mr. Waters "did not face any realistic possibility of loss from his Equipment-leasing activity" and therefore "was not 'at risk' in those years . . . with respect to his promissory note to Cooper Leasing." (App. 18a-19a)

The Court of Appeals acknowledged that the Sixth Circuit uses a different analysis to determine whether a taxpayer is protected against loss within the meaning of section 465(b)(4). (App. 13a) The Sixth Circuit examines the taxpayer's economic exposure under the "worst-case scenario": Could the taxpayer suffer a loss if his lessee becomes insolvent or bankrupt and ceases to pay rent? If the answer is yes, the taxpayer is not protected against loss and is therefore "at risk." *See Emershaw v. Commissioner*, 949 F.2d 841, 845 (6th Cir. 1991).

REASONS FOR GRANTING THE WRIT

1. *The Court of Appeals Misinterpreted Section 465(b)(4) and Its Legislative History.* Section 465 of the Internal Revenue Code is designed to prevent taxpayers engaged in certain activities, including equipment leasing, from deducting tax losses in

excess of their potential economic losses from the activity. S. Rep. No. 938 (Part I), 94th Cong., 2d Sess. 48 (1976), *reprinted in* 1976 U.S.C.C.A.N. 3439, 3483. For any given tax year, deductible losses are limited to the amount for which the taxpayer is "at risk"—and which the taxpayer could actually lose—in connection with the activity. 26 U.S.C. § 465(a)(1).

Generally, a taxpayer is at risk to the extent of cash invested in the activity, plus borrowed amounts for which the taxpayer is personally liable. 26 U.S.C. §§ 465(b)(1), (2). Section 465(b)(4) provides, however, that notwithstanding the general rule, a taxpayer shall not be considered at risk with respect to "amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements." Thus, section 465(b)(4) is concerned with distinguishing between taxpayers who have insulated themselves from economic exposure and those who have not.

In this case, Mr. Waters' negotiable purchase money note was fully recourse. Mr. Waters' obligation to pay the note was unconditional, whether or not he received rent payments from Equitable, his lessee. Nevertheless, the Court of Appeals ruled that the cumulative effect of certain features of the transaction in which Mr. Waters participated constituted an "other similar arrangement" that protected him against loss. Essentially, the Court of Appeals concluded that the protection against loss resulted from the "circular" payment obligations of Messrs. Waters and Moffatt, Cooper Leasing and Equitable. (App. 15a-16a)

The Court of Appeals reasoned:

> The payments on Waters' nominally recourse notes were essentially identical to the payments Waters was entitled to receive from Equitable on its lease. . . .
>
> . . . Although it is theoretically possible that one of the parties might have broken the chain of payments, there appears to have been no reason for this to occur.

> . . . [I]f Equitable stopped making payments on its lease, it could only have expected a chain reaction resulting in Waters and Moffatt, and then Cooper Leasing, ceasing to make payments as well. Any ensuing litigation would similarly have resulted in a chain reaction. Whether or not a litigant would be entitled to setoff in a particular court action, it is clear that once the dust settled, the claims among the parties would have cancelled each other out.

The analysis of the Court of Appeals is flawed. In determining whether Mr. Waters was protected against loss, the Court of Appeals disregarded the potential insolvency or bankruptcy of Equitable. If Equitable had stopped making payments on its lease because it was unable to make the payments, it is far from clear that "once the dust settled, the claims among the parties would have cancelled each other out." On the contrary, once the dust settled Mr. Waters would have paid his note to Cooper Leasing, but he might have been unable to collect anything on his claim against an insolvent Equitable.

The unfortunate reality is that, since the early 1980's, many equipment leasing companies have filed for bankruptcy protection. See, *e.g.*, Isadore Barmash, *Bankruptcy Petition is Filed by O.P.M.*, N.Y. Times, March 12, 1981, at D1; *Creditors Accept Itel Reorganization*, N.Y. Times, May 25, 1982, at D4; Melinda Wilson, *CMI Corp. Owner Files for Chapter 11*, Crains Detroit Business, January 23, 1989, at 3. If Equitable had been in bankruptcy, it could have rejected the lease of the equipment from Messrs.Waters and Moffatt pursuant to section 365 of the Bankruptcy Code, 11 U.S.C. § 365. Payment of rent would have ceased after rejection, but rejection would not have absolved Mr. Waters of his recourse liability to Cooper Leasing. Rejection of the lease would have broken the circle of payments, leaving Mr. Waters fully exposed on his note. Equitable would have been required to enforce Cooper Leasing's note for the benefit of its creditors, and Cooper Leasing would have enforced Mr. Waters' note. Mr. Waters would have had only a

pre-petition general claim against Equitable for breach of the lease. *See* 11 U.S.C. § 365(g). That claim might have yielded little or nothing.

Moreover, Mr. Waters' purchase money note was fully negotiable. If Cooper Leasing had negotiated Mr. Waters' note to a holder in due course, the circle of payment obligations would have been broken, the relationship between Cooper Leasing and Equitable would have been irrelevant, and any purported protection against loss would have vanished. *See* James J. White & Robert S. Summers, *Uniform Commercial Code* § 14-9 (3d ed. 1988). Mr. Waters would have had to make payments on his note without regard to what he received from Equitable.

The lease of the equipment to Equitable provided Mr.Waters with a source of payments with which to satisfy his obligations on his purchase money note. The "protection" provided by the lease would last just as long as the stream of rental payments continued. If the rental income stream dried up, there was no "arrangement" protecting Mr. Waters against loss on his fully recourse note.

The Court of Appeals held that section 465(b)(4) "operates 'to suspend at risk treatment where a transaction is structured—by whatever method—to remove any realistic possibility that the taxpayer will suffer an economic loss *if the transaction turns out to be unprofitable*.' " (App. 15a (quoting *American Principals Leasing Corp. v. United States*, 904 F.2d 477, 483 (9th Cir. 1990); other citations omitted) (emphasis added)) But, in fact, the Court of Appeals never analyzed what would have happened if the transaction in which Mr. Waters participated had turned out to be unprofitable because Equitable was unable to pay rent.

The Court of Appeals correctly concluded that, as long as the transaction did *not* turn sour, it was unlikely Mr. Waters would be called on to pay his note from his personal resources. But instead of recognizing what would have happened if the trans-

action *had* gone sour, the Court of Appeals, in effect, required Mr. Waters to demonstrate a "realistic possibility" that the transaction *would* go sour. That is not the correct construction of section 465(b)(4). Section 465 does not require a taxpayer to make a bad investment in order to be at risk. The taxpayer need only be exposed to economic loss if the investment turns out to be bad. Whether Mr. Waters was at risk does not depend on the degree of probability of a default by Equitable in payment of rent. It depends on whether, if there *was* a rent default, Mr. Waters was protected against loss on his note. Mr. Waters had no such protection in the event the rent was not paid.

The single most significant risk to a lessor of equipment is the risk of the lessee's default. Generally speaking, lessees do not default on a whim. They default because they are in financial difficulty. Nevertheless, the Court of Appeals mistakenly believed that the legislative history of section 465 precluded any consideration of Equitable's potential insolvency in evaluating whether Mr. Waters was protected against loss.

The Court of Appeals relied on a single footnote in the legislative history. That footnote states:

> For purposes of [section 465(b)(4)], it will be assumed that a loss-protection guarantee, repurchase agreement or insurance policy will be fully honored and that the amounts due thereunder will be fully paid to the taxpayer. The possibility that the party making the guarantee to the taxpayer, or that a partnership which agrees to repurchase a partner's interest at an agreed price, will fail to carry out the agreement (because of factors such as insolvency or other financial difficulty) is not to be material unless and until the time when the taxpayer becomes unconditionally entitled to payment and, at that time, demonstrates that he cannot recover under the agreement.

S. Rep. No. 938 (Part I), 94th Cong., 2d Sess. 50 n.6 (1976), *reprinted in* 1976 U.S.C.C.A.N. 3439, 3486 n.6.

The footnote mentions three different "collateral" arrangements (a guarantee, a repurchase agreement and an insurance policy) that can protect a taxpayer against loss if a transaction turns out to be unprofitable. There is only one reasonable way to read the footnote: In determining whether the taxpayer is protected against loss, it must be assumed that such a collateral loss-limiting arrangement will be honored if the transaction itself goes sour.

Section 465(b)(4) is intended to distinguish between taxpayers who have protected themselves by entering into loss-limiting arrangements and those who have not. The risk that a collateral loss-limiting arrangement will not be honored always exists. If that possibility were sufficient to preclude protection against loss, section 465(b)(4) would never have any application. A taxpayer could never be protected against loss.

The case is very different where it is the structure of the taxpayer's transaction itself that purportedly provides protection against loss. Congress cannot have intended the language in its footnote to preclude consideration of the potential insolvency or bankruptcy of a party on which the financial viability of the taxpayer's transaction depends. To read the footnote in that way is to impute to Congress a logical inconsistency: A taxpayer is at risk if he will bear the economic loss should the transaction go sour; but in determining whether the taxpayer is at risk, the possibility that the transaction will go sour cannot be considered.

No taxpayer will lose economically if the transaction in which he participates turns out well. The at-risk analysis is concerned with the taxpayer's economic exposure if the transaction turns out badly. In evaluating whether a taxpayer is at risk, therefore, the potential insolvency or bankruptcy of a key participant in the transaction (in this case, Equitable, the lessee of the equipment from Mr. Waters) *must* be considered.

By failing to take into account the potential insolvency or bankruptcy of Equitable, the Court of Appeals adopted an approach that is not only logically flawed but also administratively unworkable. The "realistic possibility" and "year-end economic realities" touchstones adopted by the Court of Appeals demand an annual economic analysis of the likelihood that the transaction will go sour. Neither taxpayers nor the Internal Revenue Service can reasonably be expected to undertake such analyses. The courts cannot be expected to review them. By contrast, the analysis required by the footnote in the legislative history of section 465(b)(4) is modest indeed. Only when the basic transaction has in fact gone sour and the taxpayer becomes unconditionally entitled to payment under a collateral loss-limiting arrangement does the taxpayer's inability to collect become relevant.

It is not the function of the courts to apply their own business judgment to evaluate the business risks of a taxpayer's transaction. That the courts are ill-equipped to do so is amply demonstrated by the opinion of the Court of Appeals, which is replete with *a priori* judgments about the degree of risk to which Mr. Waters was exposed. *See, e.g.*, App. 15a ("there was no realistic possibility that Waters would suffer an economic loss"; "the virtual identity of the composition and control of Equitable and Cooper Leasing . . . belies any likelihood that Equitable would have stopped making lease payments"; "[a]lthough it is theoretically possible that one of the parties might have broken the chain of payments, there appears to have been no reason for this to occur"); App. 16a ("the possibility that Cooper Leasing would negotiate Waters' note [was] more theoretical than realistic"). The opinion of the Court of Appeals does not reveal any empirical basis for these judgments.

2. *There Is a Conflict Among the Circuits Which This Court Should Resolve*. The decision of the Court of Appeals below, and the decisions in *American Principals Leasing Corp. v. United States*, 904 F.2d 477 (9th Cir. 1990), and *Young v. Commissioner*, 926 F.2d 1083 (11th Cir. 1991), cannot be reconciled

with *Emershaw v. Commissioner*, 949 F.2d 841 (6th Cir. 1991).*

The majority opinion in *Emershaw* (like the dissenting opinion in *American Principals*) considers the "worst-case scenario" in determining whether a taxpayer is protected against loss within the meaning of section 465(b)(4). It analyzes who has the ultimate financial exposure if the transaction goes sour. It recognizes that economic exposure is created by commercial law and that the determination of whether a taxpayer has limited his economic exposure requires consideration of the rights and obligations created by local law and by federal bankruptcy law.

In contrast, the decision below, the majority opinion in *American Principals*, and the decision in *Young* frame the question differently: Is there a realistic possibility that the taxpayer will suffer an economic loss if the transaction turns out to be unprofitable? These decisions purport to evaluate the degree of the taxpayer's economic exposure. But they focus so exclusively on the notion of "realistic possibility" that they forget the other part of the question—"if the transaction turns out to be unprofitable." In misguided reliance on a Congressional footnote dealing with loss-limiting arrangements collateral to the taxpayer's transaction, they refuse to consider the possibility that the transaction itself will go sour.

Moreover, litigation in the Tax Court involving the application of section 465(b)(4) has become a "crap shoot." On facts

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* The Eighth Circuit's decision in *Moser v. Commissioner*, 914 F.2d 1040 (8th Cir. 1990), is factually distinguishable from the present case and from *American Principals*, *Young* and *Emershaw*, although the Court of Appeals did not recognize the distinction. In *Moser*, Finalco sold computer equipment, subject to an end-user lease, to Lease Pro for cash and Lease Pro's obligation to deliver promissory notes. Lease Pro sold the computer equipment, subject to the end-user lease, to the taxpayers, who leased the computer equipment to Finalco. Finalco released Lease Pro from its obligation to deliver its own promissory notes in exchange for delivery to Finalco of the taxpayers' notes. That release extinguished the three-party nature of the transaction and gave the taxpayers a direct right of setoff in the event Finalco defaulted on its rental obligations under its lease of the equipment.

that are not materially distinguishable, decisions have been anything but consistent. Compare, *e.g.*, *Brady v. Commissioner*, T.C. Memo. 1990-626, 60 T.C.M. (CCH) 1415, 1419-21, and *Emershaw v. Commissioner*, T.C. Memo. 1990-246, 59 T.C.M. (CCH) 621, 630-31, *aff'd*, 949 F.2d 841 (6th Cir. 1991), with *Thornock v. Commissioner*, 94 T.C. 439, 449-54 (1990), and *Van Roekel v. Commissioner*, T.C. Memo. 1989-74, 56 T.C.M. (CCH) 1297, 1307-08. In each of these cases the underlying debt was nonrecourse, the transaction was structured to provide for circular payments and there was some sort of guarantee by a participant (or a party related to a participant) of the rent due under the taxpayer's lease of the equipment. The court's "analysis" in *Brady* consisted of a comparison of the facts of that case with those of *Emershaw* and *Van Roekel*. Without explanation, concluding that the facts were closer to those in *Emershaw* than to those in *Van Roekel*, the court in *Brady* found that the taxpayer was not protected against loss. 60 T.C.M. at 1421. *Emershaw* explicitly considered the potential bankruptcy of the lessee of the equipment in determining whether the taxpayer was protected against loss. 59 T.C.M. at 631. Consideration of the lessees' potential bankruptcy was explicitly rejected by the court in both *Thornock*, 94 T.C. at 454, and *Van Roekel*, 56 T.C.M. at 1308.

Unless the conflict is resolved by this Court, section 465(b)(4) will be applied in such a way as to cause disparate tax treatment based upon the happenstance of a taxpayer's geographic location, and chaos will continue to reign in the Tax Court.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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January 6, 1993

APPENDIX

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 1512—August Term, 1991

(Argued: May 5, 1992 Decided: October 21, 1992)

Docket No. 92-4023

JOHN J. WATERS and JEANNE M. WATERS,

Petitioners-Appellants,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Before:

PRATT, MAHONEY, and MCLAUGHLIN,

Circuit Judges.

Appeal from a decision of the United States Tax Court, Stephen J. Swift, *Judge*, which held that a taxpayer was not "at risk" within the meaning of § 465 of the Internal Revenue Code of 1954 with respect to a note executed in connection with an investment in computer equipment. We affirm.

STEPHEN D. GARDNER, New York, New York (Ann-Elizabeth Purintun, Peter L. Ente, Kronish, Lieb, Weiner & Hellman, New York, New York, of counsel), *for Petitioners-Appellants*.

BRUCE R. ELLISEN, Attorney, Tax Division, Department of Justice, Washington, D.C. (James A. Bruton, Acting Assistant Attorney General, Gary R. Allen, William J. Patton, Attorneys, Tax Division, Department of Justice, Washington, D.C.), *for Respondent-Appellee*.

MAHONEY, *Circuit Judge*:

John J. and Jeanne M. Waters appeal from a decision of the United States Tax Court, Stephen J. Swift, *Judge*, which ruled, *inter alia*, that John Waters ("Waters") was protected against loss, and therefore not "at risk" within the meaning of § 465 of the Internal Revenue Code of 1954,[1] with respect to a nominally recourse note executed

1 All statutory references herein are to the Internal Revenue Code of 1954 (26 U.S.C.) as amended and in effect during the years at issue. The Code has since been redesignated as the Internal Revenue Code of 1986. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 2, 100 Stat. 2085, 2095.

As pertinent herein, § 465 provides:

DEDUCTIONS LIMITED TO AMOUNT AT RISK.

(a) *Limitation to Amount at Risk.*

(1) *In General.*—In the case of —

(A) an individual, ...

engaged in an activity to which this section applies, any loss from such activity for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk (within the meaning of subsection (b)) for such activity at the close of the taxable year. (*footnote continued*)

in connection with his investment in the purchase and lease of peripheral computer equipment. *Waters v. Commissioner*, 62 T.C.M. (CCH) 778 (1991).

---

(2) *Deduction in succeeding year.*—Any loss from an activity to which this section applies not allowed under this section for the taxable year shall be treated as a deduction allocable to such activity in the first succeeding taxable year.

. . . .

(b) *Amounts Considered at Risk.*

(1) *In General.*—For purposes of this section, a taxpayer shall be considered at risk for an activity with respect to amounts including—

(A) the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity, and

(B) amounts borrowed with respect to such activity (as determined under paragraph (2)).

(2) *Borrowed amounts.*—For purposes of this section, a taxpayer shall be considered at risk with respect to amounts borrowed for use in an activity to the extent that he—

(A) is personally liable for the repayment of such amounts . . . .

(4) *Exception.*—Notwithstanding any other provision of this section, a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

(5) *Amounts at risk in subsequent years.*—If in any taxable year the taxpayer has a loss from an activity to which subsection (a) applies, the amount with respect to which a taxpayer is considered to be at risk (within the meaning of subsection (b)) in subsequent taxable years with respect to that activity shall be reduced by that portion of the loss which (after the application of subsection (a)) is allowable as a deduction.

(c) *Activities To Which Section Applies.*

(1) *Types of activities.*—This section applies to any taxpayer engaged in the activity of—

. . . .

(C) leasing any section 1245 property (as defined in section 1245(a)(3)).

. . . .

(d) *Definition of Loss.*

For purposes of this section, the term "loss" means the excess of the deductions allowable under this chapter for the taxable year (determined

(footnote continued)

We affirm.

Background

John J. and Jeanne M. Waters, husband and wife, filed joint federal income tax returns for the years 1982 through 1985. They claimed on those returns losses attributable to Waters' computer leasing activity, which we now describe.

On March 26, 1981, Equitable Financial Management, Inc. ("Equitable"), an equipment leasing company, contracted to purchase a large quantity of new peripheral computer equipment (the "Equipment") from ITT Courier, Inc. ("ITT") for $278,775, reflecting a seven to ten percent quantity discount. The equipment was to be delivered in stages throughout 1981 and 1982.

During the years at issue, Charles L. Dixon, president of Equitable, and Fred E. Cooper, its secretary, each owned fifty percent of the voting and nonvoting stock of Equitable, with the exception of a small minority stock interest held by another individual.

Equitable financed approximately the full purchase price of the Equipment by borrowing, on a nonrecourse basis, from the First National Bank of Allentown ("Allentown"). Equitable granted Allentown a security interest in the Equipment and assigned to Allentown the lease payments due under all end-user leases of the Equipment. Some or all of this loan was subsequently refinanced with another bank.

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without regard to the first sentence of subsection (a)) and allocable to an activity to which this section applies over the income received or accrue by the taxpayer during the taxable year from such activity. . . .

On April 6, 1981, Equitable leased the Equipment to Duquesne Light Company ("Duquesne") for an initial term of five years and seven months (from the date of installation of each particular piece of equipment) running through March 16, 1988. The lease terms were "net," with all costs and obligations relating to the Equipment to be borne by Duquesne. The lease payments effectively matched Equitable's payments on the bank loan.

On August 31, 1982, Equitable sold the Equipment, subject to the end-user lease and bank liens, to Cooper Leasing Corp. ("Cooper Leasing") for $298,000. The purchase price was paid with a cash payment of $1,000 and a recourse promissory note in the amount of $297,000. Interest was set at twelve percent per annum, and payments designated as prepaid interest, deferred interest, or interest were to be made as follows: $10,000 on August 31, 1982; $26,643 on February 28, 1983; $27,720 on February 28, 1984; $934.25 per month from September 1982 through December 1984. Payments of $5,806.42 per month for principal and interest were to be made from January 1985 to December 1990. Cooper Leasing provided Equitable with a security interest in the Equipment and end-user lease to secure performance of the note obligations.

Cooper Leasing was in the business of equipment and real estate leasing. In 1982, however, it was in the process of winding down its business activities and thereafter served as an intermediary between Equitable and third-party investors with respect to leasing transactions. Cooper was Cooper Leasing's president and Dixon was its secretary. Cooper and Dixon each owned fifty percent of Cooper Leasing's stock. Thus, the ownership and officers of Cooper Leasing were substantially the same as those of Equitable.

Also on August 31, 1982, simultaneously with the sale of the Equipment by Equitable to Cooper Leasing, Waters and Gerald A. Moffatt each purchased a fifty percent undivided interest in the Equipment, subject to the end-user lease and bank liens, from Cooper Leasing for a stated purchase price of $300,000. Waters and Moffatt each made a cash payment of $1,500 and provided a recourse promissory note in the amount of $148,500. Interest was set at twelve percent per annum, and principal and interest payments were to be made at times and in amounts (when aggregated) that matched the payment obligations of Cooper Leasing under its promissory note to Equitable. Waters and Moffatt each provided Cooper Leasing with a security interest in the Equipment and end-user lease to secure performance of their note obligations.

Contemporaneously with their purchase of the Equipment, Waters and Moffatt leased the Equipment to Equitable for an eight-year and four-month fixed term, coterminous with their promissory notes to Cooper Leasing and Cooper Leasing's promissory note to Equitable. Equitable was to make monthly rental payments that essentially matched the monthly note payments due from Waters and Moffatt to Cooper Leasing and the monthly note payments due from Cooper Leasing to Equitable. Additionally, the lease included the following indemnification provision:

> [Equitable] will indemnify [Waters and Moffatt] and protect defend and hold [them] harmless from and against any and all loss, cost, damage, injury or expense, including, without limitation, reasonable attorneys' fees, wheresoever and howsoever arising which [they] may incur by reason of any breach by [Equitable] of any of the representations by, or obligations of, [Equitable] contained in this Lease, the

> Equipment, claims of Senior Lienholders, Underlying Lessee, or the leasing, subleasing, use, operation or maintenance of the Equipment.

There were no rental payments that corresponded with the nonmonthly interest payments under the Cooper Leasing, Waters, and Moffatt notes due August 31, 1982, February 28, 1983, and February 28, 1984. Approximately half of these payments, which flowed through to Equitable in an aggregate amount of $64,363, was apparently intended to fund payments on those dates to Parkside Associates, a leasing consultant retained by agreement dated August 31, 1982 (the "Management Agreement") to act as the administrator or manager of the various contracts between Waters, Moffatt, Equitable, and Cooper Leasing. In any event, Waters concedes in his appeal brief that: "The obligations of Messrs. Waters and Moffatt on their Notes to Cooper Leasing essentially matched Cooper Leasing's obligations on its note to Equitable, which essentially matched Equitable's rent payment obligations under the Equitable Lease." Further, as will appear, the Tax Court allowed Waters to deduct interest actually paid on his note obligations in the year of payment.

The Management Agreement also provided that Cooper Leasing was to collect Equitable's monthly rental payments on behalf of Waters and Moffatt and apply the rental payments (1) to discharge the monthly note payments due from Waters and Moffatt on their notes to Cooper Leasing, and then (2) to discharge Cooper Leasing's monthly obligations on its note to Equitable. Cooper Leasing was to retain a ten dollar monthly fee for these services.

In summary, the resulting lease and ownership arrangements were as follows:

- Waters and Moffatt owned the Equipment, subject to the bank liens and end-user lease.
- The banks retained a security interest in the Equipment and were assigned the end-user lease payments.
- Waters and Moffatt leased the Equipment to Equitable.
- Equitable leased the Equipment to Duquesne.

The resulting payments were structured as follows:

- Equitable was obligated, on a nonrecourse basis, to make payments to the banks pursuant to the financing of the initial purchase of the Equipment from ITT.
- Duquesne made monthly rental payments pursuant to the end-user lease to the banks that effectively matched Equitable's obligations on the bank loan.
- Equitable made monthly rental payments to Waters and Moffatt on its lease of the Equipment.
- Waters and Moffatt made corresponding monthly note payments to Cooper Leasing on their purchase of the Equipment, which were satisfied by Cooper Leasing's collection of the monthly rental payments from Equitable on behalf of Waters and Moffatt.
- Cooper Leasing made corresponding monthly payments on its note to Equitable.

As a result of depreciation, interest, and management fees stemming from his investment in the Equipment, Waters claimed deductions for losses on his Federal income tax returns for 1982 through 1985 as follows:

$30,822 for 1982, $44,115 for 1983, $42,665 for 1984, and $12,213.59 for 1985. The Commissioner disallowed the losses, which resulted in asserted (1) income tax deficiencies for each year; (2) increased interest for each year because of a substantial underpayment of income taxes attributable to tax motivated transactions, pursuant to § 6621(c); and (3) as to all years except 1985, a twenty-five percent addition to the assessed deficiency for substantial understatement of income tax, pursuant to § 6661. The disallowances were based primarily upon the Commissioner's determinations that: (1) Waters did not have the benefits and burdens of ownership of the Equipment; (2) his Equipment transactions were not conducted for profit; (3) his Equipment transactions were sham or lacked economic substance; and/or (4) the loss deductions were limited by § 465. Waters filed a petition with the United States Tax Court seeking a redetermination of the asserted deficiencies, and a trial was held.

The Tax Court determined that: (1) "the transaction before [it] in this case was not a sham transaction lacking in economic substance and [Waters] had an actual and honest profit objective for entering into the transaction," 62 T.C.M. at 786; and that Waters "acquired ownership of the computer equipment and that the interest actually paid by [Waters] on his written debt obligations associated with the transaction is deductible in the year paid." *Id.* (citing *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985); *Rose v. Commissioner*, 88 T.C. 386, 423-24 (1987), *aff'd*, 868 F.2d 851 (6th Cir. 1989)).

The court also ruled, however, that Waters was not at risk with respect to his debt obligation to Cooper Leasing within the meaning of § 465(a)(1)(A) and § 465(b) because that obligation was "protected against loss through nonrecourse financing, guarantees, stop loss

agreements, or other similar arrangements" within the meaning of § 465(b)(4). 62 T.C.M. at 782-84. Specifically, the court determined that the nonrecourse nature of the underlying bank debt, the circular, matching payment obligations, and the Equitable indemnification agreement

> establish that there was no realistic possibility that [Waters] would suffer an economic loss in connection with the transactions in issue. The cumulative effect of these provisions constitutes a prohibited 'other similar arrangement' under section 465(b)(4) that effectively immunize[d] [Waters] from any economic loss with respect to [his] debt obligations under [his] nominally recourse purchase money promissory note[ ] in favor of Cooper Leasing.

Id. at 783.

As a result of these rulings, the Tax Court reduced the income tax deficiencies assessed by the Commissioner for the years 1982-1984, and determined that Waters had made an overpayment for 1985. The court also determined that Waters had substantial authority for claiming the Equipment-related deductions, thus eliminating the § 6661 addition to tax, *id.* at 786, but that penalty interest should be imposed pursuant to § 6621(c). *Id.* at 787.

Waters appeals, challenging the Tax Court's ruling as to § 465. The Commissioner does not contest the Tax Court determinations in Waters' favor.

Discussion

As a preliminary matter, we note that " '[o]ur usual standards of review . . . apply. The Tax Court's legal conclusions will receive plenary review. Factual findings will be reversed only if "clearly erroneous." ' " *Bausch &*

Lomb Inc. v. Commissioner, 933 F.2d 1084, 1088 (2d Cir. 1991) (quoting *Eli Lilly & Co. v. Commissioner*, 856 F.2d 855, 861 (7th Cir. 1988) (quoting *Anderson v. City of Bessemer City*, 470 U.S. 564, 573 (1985))). Specifically, the Tax Court's application of the at-risk rules of section 465 is a legal issue which we review *de novo*. *See Moser v. Commissioner*, 914 F.2d 1040, 1044 n.11 (8th Cir. 1990); *Casebeer v. Commissioner*, 909 F.2d 1360, 1368 (9th Cir. 1990).

The Tax Court determined that (1) the nonrecourse underlying bank debt, (2) the circular, matching payment obligations, and (3) the indemnification provided by Equitable to Waters cumulatively constituted an "other similar arrangement" under section 465(b)(4) by which Waters was effectively protected against loss in connection with his debt. 62 T.C.M. at 782-84. Waters contends, however, that he was not protected against potential economic loss by this arrangement, and therefore should be considered at risk with respect to his recourse purchase money note to Cooper Leasing.

In order to prevent taxpayers engaged in certain activities from deducting losses in excess of their actual economic investment therein, § 465(a)(1) provides that a taxpayer engaged in an activity to which § 465 applies may deduct "any loss from such activity for the taxable year . . . only to the extent of the aggregate amount with respect to which the taxpayer is at risk . . . for such activity at the close of the taxable year." The general rule is that a taxpayer is at risk for the amount of cash invested in the activity and for amounts borrowed for which the taxpayer is personally liable. § 465(b)(1), (2). Section 465(b)(4) provides, however, that a taxpayer "shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees,

stop loss agreements, or *other similar arrangements* [emphasis added]."

Any loss disallowed under section 465 for a given taxable year "shall be treated as a [§ 465] deduction allocable to such activity in the first succeeding taxable year," § 465(a)(2), and thus may be carried forward and claimed in a later year in which a risk materializes that was not operative at the close of any prior taxable year. *See Moser*, 914 F.2d at 1049 (§ 465 deduction not allowed unless and until risk-precipitating event occurs or a realistic possibility develops that it might); *American Principals Leasing Corp. v. United States*, 904 F.2d 477, 483 (9th Cir. 1990) (same); S. Rep. No. 938, 94th Cong., 2d Sess. 48 (1976), *reprinted in* 1976 U.S.C.C.A.N. 2897, 3484 ("Losses . . . are suspended under this provision").

Although we have not previously addressed the impact of § 465 upon an equipment leasing transaction of the structure presented by this appeal, other circuits have done so, and with one exception have sided with the position taken by the Commissioner in this case. The leading case is *American Principals*, in which the Ninth Circuit observed that § 465 "nowhere explains the phrase 'other similar arrangements,' " 904 F.2d at 482, but noted that "subsection 454(b)(4)'s use of the term 'arrangement' rather than 'agreement' indicates that a binding contract is not necessary for this subsection to be applicable," *id.* at 482-83, and concluded:

> [T]he purpose of subsection 465(b)(4) is to suspend at risk treatment where a transaction is structured—by whatever method—to remove any realistic possibility that the taxpayer will suffer an economic loss if the transaction turns out to be unprofitable. A theoretical possibility that the taxpayer will suffer eco-

> nomic loss is insufficient to avoid the applicability of this subsection. We must be guided by economic reality. If at some future date the unexpected occurs and the taxpayer does suffer a loss, or a realistic possibility develops that the taxpayer will suffer a loss, the taxpayer will at that time become at risk and be able to take the deductions for previous years that were suspended under this subsection. I.R.C. § 465(a)(2).

Id. at 483 (citations omitted).

The Eleventh and Eighth Circuits have adopted this rule. *See Young v. Commissioner*, 926 F.2d 1083, 1088-89 (11th Cir. 1991); *Moser*, 914 F.2d at 1048. The Sixth Circuit takes a contrary view, however, agreeing with the view of the dissent in *American Principals* that the legislative history of § 465 "indicate[s] that a loss-limiting arrangement within the meaning of § 465(b)(4) is a *collateral agreement* protecting a taxpayer from loss *after the losses have occurred*, either by excusing him from his obligation to make good on the losses or by compensating him for losses he has sustained." *Emershaw v. Commissioner*, 949 F.2d 841, 849 (6th Cir. 1991) (citing *American Principals*, 904 F.2d at 487 (Hug, J., dissenting)).

The legislative history upon which *Emershaw* relies, *see* 949 F.2d at 848-49, is primarily the following excerpt from the Senate report accompanying the initial enactment of § 465 in 1976:

> [A] taxpayer's capital is not "at risk" in the business, even as to the equity capital which he has contributed[,] to the extent he is protected against economic loss of all or part of such capital by reason of an agreement or arrangement for compensation or reimbursement to him of any loss which he may suffer. Under this concept, an investor is not "at risk" if

> he arranges to receive insurance or other compensation for an economic loss *after the loss is sustained*, or if he is entitled to reimbursement for part or all of any loss by reason of a binding agreement *between himself and another person*.

S. Rep. No. 938 at 49, *reprinted in* 1976 U.S.C.C.A.N. at 3485 (emphasis added, paralleling *Emershaw*).

We do not regard this statement as dispositive with respect to the meaning of "other similar arrangements" in § 465(b)(4). While the Senate report outlines some arrangements that fall within § 465(b)(4), it does not directly address the language of that provision or purport to provide an exhaustive description of its coverage.

In any event, " '[w]here . . . the resolution of a question of federal law turns on a statute and the intention of Congress, we look first to the statutory language and then to the legislative history if the statutory language is unclear.' " *Toibb v. Radloff*, 111 S. Ct. 2197, 2200 (1991) (quoting *Blum v. Stenson*, 465 U.S. 886, 896 (1984)). Accordingly, our primary focus must be upon the language of § 465(b)(4). That language prompts disagreement with *Emershaw*'s conclusion that the term "similar arrangements" under § 465(b)(4) encompasses only "*collateral agreement[s]* protecting a taxpayer from loss *after the losses have occurred*." *Emershaw*, 949 F.2d at 849. As *American Principals* points out, the statutory phrase is "similar arrangements," not "agreements." 904 F.2d at 482-83. Moreover, the "arrangements" may be "similar" not only to "guarantees" and "stop loss agreements," but also to "nonrecourse financing," ordinarily a *prearrangement* to protect against loss.[2]

2 In any event, so far as the outcome of this appeal is concerned, Equitable provided Waters with an indemnification that constitutes a collateral agreement to protect Waters against loss after it occurred.

We join the Eighth, Ninth, and Eleventh Circuits in holding that § 465(b)(4) operates "to suspend at risk treatment where a transaction is structured—by whatever method—to remove any realistic possibility that the taxpayer will suffer an economic loss if the transaction turns out to be unprofitable." *American Principals*, 904 F.2d at 483; *see also Young*, 926 F.2d at 1089; *Moser*, 914 F.2d at 1048-49; S. Rep. No. 1263, 95th Cong., 2d Sess. 67 (1978), *reprinted in* 1978 U.S.C.C.A.N. 6761, 7103 (§ 465 limits "at risk" treatment to "the amount the taxpayer has placed at risk and *could actually lose* from the activity" (emphasis added)). Economic reality is the touchstone of the required analysis. *See Young*, 926 F.2d at 1088 & n.11; *Moser*, 914 F.2d at 1048 & n.21; *American Principals*, 904 F.2d at 483.

In this case, there was no realistic possibility that Waters would suffer an economic loss if the underlying transaction became unprofitable. First, the circular nature of the arrangement between Waters and Moffatt, Cooper Leasing, and Equitable effectively immunized Waters from economic loss. Equitable was both the initial obligee and final obligor. The payments on Waters' nominally recourse notes were essentially identical to the payments Waters was entitled to receive from Equitable on its lease. The only obligation outside the circle of transactions was a nonrecourse bank debt.

Second, the virtual identity of the composition and control of Equitable and Cooper Leasing, the only entities transferring funds, belies any likelihood that Equitable would have stopped making lease payments. Although it is theoretically possible that one of the parties might have broken the chain of payments, there appears to have been no reason for this to occur.

Third, if Equitable stopped making payments on its lease, it could only have expected a chain reaction resulting in Waters and Moffatt, and then Cooper Leasing, ceasing to make payments as well. Any ensuing litigation would similarly have resulted in a chain reaction. Whether or not a litigant would be entitled to setoff in a particular court action, it is clear that once the dust settled, the claims among the parties would have cancelled each other out.

Fourth, if Duquesne stopped making lease payments, the banks could have only looked to the Equipment to recover their funds. Although Dixon testified that he "personally regarded Equitable as fully liable on a recourse basis on the bank loan and that [in the event of a default] Equitable would have insisted on full payment by Cooper Leasing and by [Waters] and Moffatt of their debt obligations under their 'recourse' promissory notes," 62 T.C.M. at 783, the Tax Court was not clearly erroneous in rejecting this testimony. In any event, the pertinent "arrangement" to be assessed at the close of each taxable year was the existing nonrecourse debt, not the theoretical possibility that its nonrecourse nature would be disregarded by Equitable in some future contingency.

Waters contends that even if the nonrecourse nature of the underlying bank debt would ordinarily protect him against loss, he was not so protected in this case because his recourse note was fully negotiable. We reject this argument. The structure of the transaction and parties at issue in this case, as well as the Management Agreement between the parties, made the possibility that Cooper Leasing would negotiate Waters' note more theoretical than realistic. If at some future date the unexpected occurred and the note was negotiated to a third party, Waters might at that juncture become at risk and be able

to take deductions unavailable in prior years. *See* § 465(a)(2). As discussed earlier, the operation of § 465 is to suspend and defer, rather than completely deny, other-wise available deductions.

Waters also contends that the matching payment obligations did not immunize Waters against loss, citing numerous Tax Court opinions, as well as *Emershaw*, in support of that view. We agree that the existence of a source of rental payments to cover a taxpayer's note obligations does not in and of itself eliminate risk, as some of the cases cited by Waters make clear. *See, e.g., Rubin v. Commissioner*, 58 T.C.M. (CCH) 25, 38 (1989) (mere fact that taxpayer would receive sufficient rent from third party to cover note payments did not result in § 465 exposure) (citing *Gefen v. Commissioner*, 87 T.C. 1471 (1986)); *B & A Distrib. Co. v. Commissioner*, 56 T.C.M. (CCH) 958, 969 (1988) (same) (citing *Gefen*). However, the additional factors presented here—the underlying nonrecourse debt, the circular, matching payment obligations, and the Equitable indemnification—take this case well beyond an unadorned availability of rental payments to cover note obligations.

Waters' essential argument, invoking *Emershaw*, 949 F.2d at 845, is that the "worst-case scenario" must be considered in applying § 465(b)(4) rather than year-end economic realities. We disagree. Rather, as stated in *Moser*:

> While it may be appropriate to examine the worst-case scenario in determining whether a taxpayer is personally liable for amounts that he has borrowed for use in an activity when applying § 465(b)(2), *see Krause [v. Commissioner*, 92 T.C. 1003, 1017 (1989)], such an analysis is not proper when determining whether the "taxpayer has engaged in a loss-

> limiting arrangement prohibited by subsection 465(b)(4)." [*American Leasing*], 904 F.2d at 482.

Moser, 914 F.2d at 1048.

Moser drew support for this analysis from the pertinent Senate report, which states:

> For purposes of [subsection 465(b)(4)], it will be assumed that a loss-protection guarantee, repurchase agreement or insurance policy will be fully honored and that the amounts due thereunder will be fully paid to the taxpayer. The possibility that the party making the guarantee to the taxpayer, or that a partnership which agrees to repurchase a partner's interest at an agreed price, will fail to carry out the agreement (because of factors such as insolvency or other financial difficulty) is not to be material unless and until the time when the taxpayer becomes unconditionally entitled to payment and, at that time, demonstrates that he cannot recover under the agreement.

S. Rep. No. 938 at 50 n.6, *reprinted in* 1976 U.S.C.C.A.N. at 3486 n.6; *see also American Principals*, 904 F.2d at 482 (quoting above passage from S. Rep. No. 938).

Finally, the language of § 465(b)(4), which is addressed to arrangements that "protect[ ] against loss," taken together with the overall structure of § 465, which defers rather than permanently disallows losses, encourages an interpretation of this statute which looks to year-end economic realities rather than worst-case scenarios. Because at the close of the tax years at issue Waters did not face any realistic possibility of loss from his Equipment-leasing activity, the Tax Court properly concluded that he was

not "at risk" in those years within the meaning of § 465 with respect to his promissory note to Cooper Leasing.

Conclusion

The decision of the Tax Court is affirmed.

T. C. Memo. 1991-462

UNITED STATES TAX COURT

John J. Waters and Jeanne M. Waters, Petitioners v. Commissioner of Internal Revnue, Respondent.

Docket No. 9938-88. Filed September 23, 1991.

Stephen D. Gardner and *Michael G. Lefkowitz*, for the petitioners.

Jody Tancer and *Laurie B. Kazenoff*, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SWIFT, *Judge*: Respondent determined deficiencies in petitioners' Federal income taxes and additions to tax as follows:

Year	*Deficiency*	*Sec. 6661 Addition to Tax*[1]
1982	$14,361	$3,590
1983	20,258	5,065
1984	18,700	4,675
1985	2,443	—

Increased interest under section 6621(c) also was determined for each year.

The primary issues for decision are: (1) Whether petitioner John J. Waters (petitioner) was at risk within the meaning of section 465 with respect to debt obligations incurred in connection with an investment in peripheral computer equipment; (2) whether petitioner's investment was a sham transaction devoid of economic substance; and (3) whether petitioner's investment constituted an activity entered into for profit within the meaning of section 183.

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1 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as in effect for the years in issue.

Findings of Fact

Some of the facts have been stipulated and are so found. Petitioners are husband and wife and resided in Huntington, New York, at the time their petition was filed.

During the years in issue, petitioner was a certified public accountant. In early 1982, petitioner and Gerald A. Moffatt (Moffatt), one of petitioner's partners at the public accounting firm at which petitioner worked, sought advice from Michael Gorin (Gorin) concerning possible investments in computer equipment leasing transactions. Gorin was a certified public accountant and had performed accounting and financial services for computer equipment leasing companies, and Gorin had given advice to other investors concerning investments in computer equipment leasing transactions. Further, Gorin had experience purchasing computer equipment for a prior employer.

On August 31, 1982, after considering and discussing for a number of months with Gorin and other colleagues various investment opportunities, including computer equipment leasing transactions, and after investigating the credit standing of the prospective end user of the equipment, petitioner and Moffatt entered into the transactions with respect to certain peripheral computer equipment described below.

Original Purchase Transaction and End-User Lease

On March 26, 1981, Equitable Financial Management, Inc. (Equitable), a general equipment leasing company, entered into a master purchase agreement to purchase a large quantity of new peripheral computer equipment from ITT Courier, Inc. (ITT), the manufacturer of the equipment. Equitable's purchase price for the particular computer equipment that is at issue in this case (and that was purchased from ITT under the referred-to master purchase agreement) was $278,775. The equipment included display terminals, keyboards, printers, printer interfaces, and remote terminal controllers. The equipment was to be delivered in stages throughout 1981 and 1982.

ITT peripheral computer equipment was highly regarded in the computer industry. The particular controllers purchased by Equitable had a redundancy feature that made them particularly attractive to financial institutions, utility companies, and other end users whose business necessitated computer equipment with backup capability.[2]

Charles L. Dixon (Dixon) was the president of Equitable. Fred E. Cooper (Cooper) was the corporate secretary. During the years in issue, Dixon and Cooper each owned 50 percent of the voting and nonvoting stock of Equitable, with the exception of a small minority stock interest held by another individual.

In connection with its purchase of the computer equipment, Equitable borrowed on a nonrecourse basis from The First National Bank of Allentown approximately the full stated purchase price of the equipment. The proceeds from the nonrecourse bank loan were used by Equitable to pay ITT the purchase price of the computer equipment. The loan was subsequently refinanced on a nonrecourse basis by another bank.

As collateral for the bank loan, Equitable gave the bank security interests in the computer equipment and in the lease payments due under all end-user leases of the equipment. Neither the term of, nor the interest rate due, on Equitable's bank loan is established in the record.

The $278,775 purchase price (for the computer equipment that is in issue in this case and that was purchased by Equitable from ITT) reflected a 7- to 10-percent discount from ITT's list price for the equipment because the purchase was part of a pur-

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2 The particular computer equipment at issue in this case and that was purchased by Equitable from ITT under the master purchase agreement and the listed prices associated with the different types of equipment are indicated below:

No. of Units	*Model*	*Price Per Unit*	*Total Price*
3	7412-C	$14,490	$43,470
3	7412-A	20,700	62,100
1	7502-3	990	990
14	2700-13	1,665	23,310
35	2700-13	2,300	80,500
17	8702	3,915	66,555
1	2700-03	1,850	1,850
	Total Purchase Price		$278,775

chase by Equitable from ITT under the master purchase agreement of a much larger quantity of computer equipment.

On April 6, 1981, Equitable entered into a master end-user lease agreement with Duquesne Light Co. (Duquesne Light), a public utility company located in Pittsburgh, Pennsylvania, with respect to the peripheral computer equipment purchased from ITT. The initial terms of the various end-user leases with Duquesne Light began on either March 16, 1982, May 27, 1982, or August 16, 1982, and had terms of 5 years and 7 months, running (depending on the installation date at Duquesne Light of the various pieces of equipment) through March 16, 1988.

During the initial 5-year 7-month lease terms, total monthly end-user lease payments in the amount of $6,953 were due from Duquesne Light with respect to the equipment. The monthly end-user lease payments effectively matched the payments due on Equitable's purchase money promissory note to the bank. Under lease renewal provisions, if Duquesne Light chose to renew the leases, Duquesne Light would pay the fair market rental rates at the time of renewal up to a maximum of 40-51 percent of the original lease rental rates.

The end-user leases with Duquesne Light were net leases under which Duquesne Light was liable for all costs and expenses of maintaining the computer equipment. In order to fulfill its obligation in that regard, Duquesne Light entered into an equipment maintenance agreement with ITT with respect to the computer equipment, under which ITT (for a fee to be paid by Duquesne Light) was obligated to provide remedial and preventive maintenance throughout the term of the end-user leases. Under the end-user lease agreements, Duquesne Light also was required to and did maintain casualty insurance on the computer equipment during the term of the end-user leases.

Sale of Computer Equipment to Cooper Leasing and to Petitioner

On August 31, 1982, 17 months after the initial master purchase agreement for the purchase of computer equipment was entered into between Equitable and ITT, two additional and

simultaneous transactions occurred (involving the particular computer equipment in issue in this case) with the objective of transferring ownership of the equipment and assignment of the end-user leases with respect to the equipment (subject to the security interests therein of the bank) to petitioner and to Moffatt.

The first transaction was a sale of the computer equipment and assignment of the end-user leases by Equitable to Cooper Leasing Corporation, Inc. (Cooper Leasing), followed by the immediate resale of the computer equipment and reassignment of the end-user leases by Cooper Leasing to petitioner and to Moffatt. Both transactions were subject to the prior security interests of the bank in the equipment and in the end-user lease payments.

The total stated price for the purchase of the computer equipment by Cooper Leasing from Equitable was $298,000 (reflecting, among other things, the fact that ITT peripheral computer equipment had appreciated in value from March of 1981 to August of 1982). The total purchase price was to be paid with a cash downpayment of $1,000 and by the execution by Cooper Leasing in favor of Equitable of a purportedly recourse promissory note in the amount of $297,000.

Interest was to accrue on the promissory note at 12 percent per year, and payments designated as-prepaid interest, deferred interest or interest were to be made as follows: $10,000 on August 31, 1982; $26,643 on February 28, 1983; $27,720 on February 28, 1984; $934 monthly from September of 1982 through December of 1984. Payments of principal and interest were to be made as follows: $5,806 monthly from January of 1985 through December of 1990.

Cooper Leasing was in the general business of equipment and real estate leasing. The officers and ownership of Cooper Leasing were the same as the officers and ownership of Equitable, except that Fred E. Cooper was president of Cooper Leasing, and Charles L. Dixon was the corporate secretary. Cooper and Dixon each owned 50 percent of the stock of Cooper Leasing.

On August 31, 1982, simultaneously with the above transaction between Equitable and Cooper Leasing, Cooper Leasing sold the computer equipment to petitioner and to Moffatt as joint tenants for a stated purchase price of $300,000, represented by cash downpayments by petitioner and by Moffatt of $1,500 each and by the execution of separate 8-year and 4-month purchase money promissory notes by petitioner and by Moffatt each in the amount of $148,500, reflecting a total purchase money debt reflected by the promissory notes of $297,000. Petitioner's and Moffatt's debt obligations to Cooper Leasing under the promissory notes were secured by security interests in the equipment executed and filed in favor of Cooper Leasing.

Interest was to accrue on petitioner's and Moffatt's promissory notes in favor of Cooper Leasing at 12 percent a year, and payments of prepaid interest, deferred interest, accrued interest, and principal with respect to each of the promissory notes were to be made in total amounts that matched the payment obligations of Cooper Leasing under its promissory note to Equitable.

Separate promissory notes in favor of Cooper Leasing were executed by petitioner and Moffatt reflecting their obligations to pay interest to Cooper Leasing of $26,643 on February 28, 1983, and $27,720 on February 28, 1984.

In their separate written $148,500 purchase money promissory notes and in their promissory notes regarding the interest payments due on February 28, 1983, and February 28, 1984, petitioner and Moffatt are stated to be personally liable, on a fully recourse basis, for the full amount of the principal and interest due thereon.

Leaseback of the Computer Equipment to Equitable

On August 31, 1982, simultaneously with the above two transactions, petitioner and Moffatt entered into an agreement leasing back the computer equipment to Equitable for a fixed term of 8 years and 4 months. Under the leaseback agreement, Equitable agreed to make monthly lease payments to petitioner and to Moffatt that essentially matched the monthly payments

due from petitioner and from Moffatt under their promissory notes in favor of Cooper Leasing and the monthly payments due from Cooper Leasing under its promissory notes in favor of Equitable.

Under a management agreement between petitioner, Moffatt, and Cooper Leasing, Cooper Leasing was to collect directly from Equitable the monthly lease payments due from Equitable under the leaseback agreement with petitioner and Moffatt. From those payments, Cooper Leasing would credit petitioner's and Moffatt's monthly debt obligations to Cooper Leasing under their promissory notes to Cooper Leasing, and Cooper Leasing in turn would transfer the payments back to Equitable in payment of its (Cooper Leasing's) debt obligations to Equitable. For its services in handling the payments and the bookkeeping, Cooper Leasing was to retain a fee of $10 a month.

In 1982, 1983, and 1984, as a result of the essentially offsetting lease and debt payment obligations, petitioner and Moffatt were to earn no net rental proceeds. In 1985 through 1988, petitioner and Moffatt would each earn $250 a year in net rental proceeds. In 1989 and later years, petitioner and Moffatt also would be entitled to additional net rental proceeds from Equitable based on a percentage of the net end-user rental proceeds Equitable realized from any re-lease of the equipment, as follows: 15 percent for 1989; 20 percent for 1990; and 50 percent for 1991 and later years.

On August 31, 1982, petitioner, Moffatt, and Equitable entered into a nonexclusive remarketing agreement under which Equitable, upon expiration of the lease agreement, could attempt to sell the used computer equipment. Under the agreement, Equitable would receive 25 percent of any net sales proceeds, and petitioner and Moffatt would receive the balance. A sale of the equipment had to be approved by petitioner and Moffatt.

The leaseback agreement between petitioner, Moffatt, and Equitable provided an indemnification provision in favor of petitioner and Moffatt, as follows:

> [Equitable] will indemnify [petitioner and Moffatt] and protect defend and hold [petitioner and Moffatt] harmless from and against any and all loss, cost, damage, injury or expense, including, without limitation, reasonable attorney's fees, wheresoever and howsoever arising which [petitioner and Moffatt] may incur by reason of any breach by [Equitable] of any of the representations by, or obligations of, [Equitable] contained in this Lease, the Equipment, claims of Senior Lienholders, Underlying Lessee, or the leasing, subleasing, use, operation or maintenance of the Equipment.

The leaseback agreement also contained a typical provision obligating Equitable to maintain casualty, property, and liability insurance coverage on the equipment.

On August 31, 1982, petitioner, Moffatt, Equitable, Cooper Leasing, and Parkside Associates (Parkside) entered into an agreement under which Parkside was to act as the manager or administrator of the various agreements between petitioner, Moffatt, Equitable, and Cooper Leasing. For its management services, Parkside was to be paid by Equitable $5,100 in August of 1982, $19,400 on February 28, 1983, and $8,000 on February 28, 1984.

Parkside was in the business of providing consulting services to those engaged in the equipment leasing business and to investors in equipment leases. In 1984, the business of Parkside was taken over by Linwood Associates. Michael Gorin was the president and sole owner of Parkside and of Linwood.

All aspects of the above sale and leaseback transactions were documented and recorded. Records were properly maintained of the income and expenses relating to the equipment.

Under the various debt and lease obligations of the parties, total annual pretax cash flow available to petitioner and to Moffatt relating to the above transactions would be as follows: During 1982 through 1984, $0; during each of 1985, 1986, 1987, and 1988, $500 ($250 to petitioner and $250 to Moffatt); during each of 1989, 1990, and 1991 and subsequent years, 15,

20, and 50 percent, respectively, of any net end-user lease proceeds received from Equitable (one half of which would be paid to petitioner and one half of which would be paid to Moffatt).

A written financial analysis of the above transactions that was provided to petitioner and to Moffatt in August of 1982 with respect to their participation in the above transactions noted the tax benefits and reflected the limited net cash flow available to petitioner and to Moffatt in the early years of the investment.

As of the time of trial, all lease payments due from Duquesne Light have been made, the equipment has been continuously and properly maintained and upgraded under the maintenance agreement with ITT, the end-user leases have been renewed by Duquesne Light at the maximum lease rental rates allowed (i.e., at 40-51 percent of the original rates), and all of the peripheral computer equipment was still on lease to Duquesne Light. Further, the bank loan Equitable obtained to finance the purchase of the computer equipment from ITT has been fully paid. Also, amounts due Equitable from Cooper Leasing under Cooper Leasing's promissory note and amounts due Cooper Leasing under petitioner's and Moffatt's promissory notes have been paid.

Petitioners' Federal income tax returns for 1982 through 1985 were filed with respondent using the cash method of accounting. Petitioners claimed thereon losses relating to the above equipment leasing transaction of $30,822 for 1982, $44,115 for 1983, $42,665 for 1984, and $12,213 for 1985. On petitioners' 1987 and subsequent years' Federal income tax returns, due to the "turnaround" of the financial aspects of the investment, petitioner reported the positive taxable income arising from the lease rentals received from Equitable in excess of depreciation and interest deductions claimed.

On audit, respondent disallowed the net losses claimed for 1982, 1983, 1984, and 1985.

At-Risk Issue

This and other courts have recently discussed at some length the at-risk limitations of section 465(b)(4) as they apply to multiparty equipment leasing transactions. See, e.g., *Moser v. Commissioner*, 914 F.2d 1040, 1047-1050 (8th Cir. 1990), affg. a Memorandum Opinion of this Court; *Casebeer v. Commissioner*, 909 F.2d 1360, 1368-1370 (9th Cir. 1990), affg. on this issue, revg. in part, and remanding *Larsen v. Commissioner*, 89 T.C. 1229 (1987), and three memorandum opinions of this Court; *American Principals Leasing Corp v. United States*, 904 F.2d 477, 482-483 (9th Cir. 1990); *Thornock v. Commissioner*, 94 T.C. 439, 447-454 (1990); *Levy v. Commissioner*, 91 T.C. 838, 862-865 (1988); *Follender v. Commissioner*, 89 T.C. 943, 949-950 (1987); *Porreca v. Commissioner*, 86 T.C. 821, 835-843 (1986). See also *Raphan v. United States*, 759 F.2d 879, 885 (Fed. Cir. 1985). It is not necessary to reiterate that discussion.

It suffices herein to note that the nonrecourse nature of the underlying third-party bank debt, the offsetting payment obligations, and the indemnification agreement that in *Thornock v. Commissioner, supra* at 447-454, were held to immunize investors against any realistic economic risk of loss (with regard to their nominally recourse purchase money debt obligations) are very similar to the nonrecourse third-party bank debt, the offsetting payment obligations, and the indemnification agreement that are presented to us this case.

Thornock v. Commissioner, supra, controls the resolution of the at-risk issue in this case. Paraphrasing our conclusions in that opinion (94 T.C. at 447-450), The First National Bank of Allentown and the bank that refinanced Equitable's purchase of the equipment from ITT on a nonrecourse basis looked only to the computer equipment and to the end-user lease payments as collateral. Neither Equitable, Cooper Leasing, Parkside, nor petitioner or Moffatt, had any liability or legal responsibility to see that the banks were repaid on the loan, except the responsibility to act in good faith with regard to other aspects

of the transactions. Other than their rights with regard to the end-user lease payments and the collateral, the banks had no legal right to require any participant in the transactions to provide funds to pay off the nonrecourse bank loan.

Dixon, the president of Equitable, testified that he personally regarded Equitable as fully liable on a recourse basis on the bank loan and that Equitable would have insisted on full payment by Cooper Leasing and by petitioner and Moffatt of their debt obligations under their "recourse" promissory notes in order to insure that Equitable had the funds to pay the nonrecourse bank loan and thereby to protect Equitable's credit standing. Under the at-risk provisions of section 465, however, we are dealing primarily with the reality of the legal relationships and debt obligations under the agreements and written obligations as entered into and documented by the parties. The fact that particular individuals or representatives of debtors on nonrecourse debt obligations personally may believe that their company should or would voluntarily treat particular debt obligations as recourse is, in our opinion, essentially meaningless.

As the transactions before us were structured, the banks had no recourse to Equitable, and Equitable had no personal liability on its promissory note to the banks. That fact and the other features and provisions of the transactions we have mentioned (particularly the indemnity agreement) establish that there was no realistic possibility that petitioner and Moffatt would suffer an economic loss in connection with the transactions in issue. The cumulative effect of these provisions constitutes a prohibited "other similar arrangement" under section 465(b)(4) that effectively immunizes petitioner and Moffatt from any economic loss with respect to their debt obligations under their nominally recourse purchase money promissory notes in favor of Cooper Leasing. See also *Moser v. Commissioner, supra* at 1049; *Casebeer v. Commissioner, supra* at 1369.

Petitioner argues that in spite of the protections built into the transactions, the bankruptcy of one of the parties to the transactions might result in an economic loss to petitioner. For example, petitioner argues that if the equipment became worth-

less in the fourth year of the end-user lease with Duquesne Light, Duquesne Light might stop making lease payments due Equitable, Equitable might stop making lease payments due petitioner and Moffatt, and petitioner and Moffatt might stop making payments due under their promissory notes to Cooper Leasing. Petitioner speculates that Cooper Leasing and/or Equitable might then assign or negotiate petitioner's and Moffatt's "recourse" promissory notes to the bank, and that the bank might then enforce against petitioner and Moffatt the assigned "recourse" promissory notes, even though the bank originally had no recourse on its loan to Equitable.

As we have previously explained, the "worst-case" analysis that is reflected in our opinions stops short of anticipating the potential bankruptcy or other financial adjustments that might occur if any of the participants providing the particular "protections-against-loss" get into financial difficulty. As stated in *Thornock v. Commissioner, supra* at 454, quoting from the legislative history of section 465—

> the potential bankruptcy of entities providing guarantees or loss protection to investors is not a consideration in determining the application of section 465(b)(4) unless and until the bankruptcy actually occurs. *Capek v. Commissioner*, 86 T.C. 14, 52 (1986). In this regard, the report of the Senate Finance Committee with respect to section 465 states as follows:
>
> For purposes of this rule [i.e., section 465(b)(4)], *it will be assumed that a loss-protection guarantee*, repurchase agreement or insurance policy *will be fully honored* and that the amounts due thereunder will be fully paid to the taxpayer. The possibility that the party making the guarantee to the taxpayer, or that a partnership which agrees to repurchase a partner's interest at an agreed price, will fail to carry out the agreement (because of factors such as insolvency or other financial difficulty) is not to be material unless and until the time when the taxpayer becomes unconditionally entitled to payment and, at that time, demonstrates that he cannot recover under the agreement.

[S. Rept. 94-938 at 50 n.6 (1976), 1976-3 C.B. (Vol. 3) 49, 88. Fn. ref. omitted; emphasis added.]

See also in this regard, *American Principals Leasing Corp. v. United States*, 904 F.2d 477, 482 (9th Cir. 1990).

Petitioner also argues that in 1982, when he first entered into the transactions, he should be considered to be at risk under section 465(b)(1) with respect to his debt obligations on the interest-only promissory notes due on February 28, 1983, and February 28, 1984, in the respective amounts of $26,643 and $27,720. We disagree. Under section 465(b)(1), a taxpayer is to be regarded as at risk only with respect to: (1) Amounts of money and the adjusted basis of property actually contributed to the activity; and (2) amounts borrowed with respect to or for use in the activity. An obligation to pay interest in the future does not so qualify. Such an obligation does not constitute a contribution of money or property to the activity, nor does it constitute the borrowing of money. If money has been borrowed and is used in the activity, such money or loan proceeds may qualify under the at-risk rules, but interest on the associated debt does not qualify until it is paid.

Porreca v. Commissioner, 86 T.C. 821 (1986), and *Lansburgh v. Commissioner*, T.C. Memo. 1987-164, are not to the contrary. In *Porreca v. Commissioner, supra* at 847, we simply treated interest actually paid as part of the taxpayer's capital cost of the investment. *Porreca* is not authority for the proposition that an obligation to pay interest in the future is to be regarded as an amount with respect to which a taxpayer is at risk under section 465.

In *Lansburgh v. Commissioner, supra*, a taxpayer was considered at risk with respect to an obligation to pay interest not because the obligation reflected an obligation to pay interest, but because the obligation also constituted part of the price to convert the underlying debt obligations to nonrecourse obligations. *Lansburgh v. Commissioner, supra*, is distinguishable from the instant case on that basis.

Petitioner is to be regarded as at risk with regard to the interest-only promissory notes only in the years petitioner's obli-

gations thereunder were actually paid (namely, in 1983 and 1984).

In light of the above resolution of the at-risk issues under section 465, it is not necessary to address respondent's alternative argument that under the remarketing agreement between petitioner, Moffatt, and Equitable, Equitable had fixed and definite rights in conflict with its creditor status that constituted a prohibited other interest under section 465(b)(3).

Sham Transaction, Economic Substance, and Profit Objective

When analyzing the substance and form of business transactions, the reality that the tax laws affect the shape of most business transactions cannot be ignored. *Frank Lyon Co. v. United States*, 435 U.S. 561, 576-580 (1978). This principle is particularly appropriate where significant tax benefits are made available for the specific purpose of promoting and stimulating the precise type of investments in issue. *Levy v. Commissioner*, 91 T.C. 838, 853 (1988); *Estate of Thomas v. Commissioner*, 84 T.C. 412, 432 (1985). In general, equipment leasing transactions would appear to qualify as a type of significantly tax-motivated transaction that Congress intended to encourage. *Levy v. Commissioner, supra* at 871-872; *Fox v. Commissioner*, 82 T.C. 1001, 1021 (1984).

It also is well established, however, that to be recognized for Federal income tax purposes, transactions must have a business purpose and economic substance apart from anticipated tax consequences. *Knetsch v. United States*, 364 U.S. 361, 366 (1960); *Goldstein v. Commissioner*, 364 F.2d 734, 740 (2d Cir. 1966), affg. 44 T.C. 284 (1965); *Hulter v. Commissioner*, 91 T.C. 371, 388 (1988). Where taxpayers resort to "the expedient of drawing up papers to characterize transactions contrary to objective economic realities and which have no economic significance beyond expected tax benefits," the tax benefits claimed will be denied on the basis that the transactions were shams. *Cooper v. Commissioner*, 88 T.C. 84, 103 (1987); *Falsetti v. Commissioner*, 85 T.C. 332, 335 (1985).

Examinations into the business purpose and economic substance of transactions are inherently factual. *Levy v. Commissioner, supra*

at 854. It is often difficult to distinguish clearly between valid and invalid transactions. *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184, 197 (1983), affd. on this issue 752 F.2d 89 (4th Cir. 1985).

The business purpose inquiry tends to be an inquiry into the taxpayer's subjective purpose for entering into the transactions in issue. *Levy v. Commissioner, supra* at 854; *Packard v. Commissioner*, 85 T.C. 397, 417 (1985). The economic substance inquiry tends to be an analysis of objective factors indicating whether the transactions had a reasonable possibility of producing a profit. *Levy v. Commissioner, supra* at 854; *Packard v. Commissioner, supra* at 417. See also *Casebeer v. Commissioner*, 909 F.2d 1360, 1363 (9th Cir. 1990), affg. on this issue, revg. in part, and remanding *Larsen v. Commissioner*, 89 T.C. 1229 (1987), and three memorandum opinions of this Court; *James v. Commissioner*, 899 F.2d 905, 908-909 (10th Cir. 1990), affg. 87 T.C. 905 (1986); *Friedman v. Commissioner*, 869 F.2d 785, 792 (4th Cir. 1989), affg. *Glass v. Commissioner*, 87 T.C. 1087 (1986); *Rose v. Commissioner*, 868 F.2d 851, 854 (6th Cir. 1989), affg. 88 T.C. 386 (1987).

In order to satisfy the profit-objective test and thereby to be entitled to claim the losses at issue in this case independently of the limitations of section 183, petitioner must also have entered into the investments with an actual and honest objective of making a profit. *Cooper v. Commissioner*, 88 T.C. 84, 108 (1987); *Fuchs v. Commissioner*, 83 T.C. 79, 98 (1984); *Dreicer v. Commissioner*, 78 T.C. 642, 646 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983). The expectation of profit need not have been reasonable, but the taxpayer must have entered into the activity with the objective of making a profit. Sec. 1.183-2(a), Income Tax Regs.; *Engdahl v. Commissioner*, 72 T.C. 659, 666 (1979); *Golanty v. Commissioner*, 72 T.C. 411, 425-426 (1979), affd. without published opinion 647 F.2d 170 (9th Cir. 1981).

Various factors set forth in the regulations under section 183 have been used in the analysis of whether the requisite profit objective exists. No one factor, however, is determinative. See sec. 1.183-2(b), Income Tax Regs. The resolution of whether a profit objective exists is to be made on the basis of all of the facts and

circumstances. *Elliott v. Commissioner*, 84 T.C. 227, 236 (1985), affd. without published opinion 782 F.2d 1027 (3d Cir. 1986); *Golanty v. Commissioner, supra* at 426. More weight is to be given to objective facts than to self-serving statements of intention. *Beck v. Commissioner*, 85 T.C. 557, 570 (1985); *Siegel v. Commissioner*, 78 T.C. 659, 699 (1982).

We do not believe that the transactions before us constitute sham transactions lacking in economic substance. The equipment existed. It was essentially new, state of the art peripheral computer equipment that was highly regarded in the computer industry and that because of its special features had a particular niche in the market place. Most significantly, the stated purchase price for the equipment was not inflated. It reflected recent market price adjustments in ITT computer equipment, and the fair market value of the equipment was reflected at each level of the various transactions.

The evidence is persuasive that the ITT peripheral computer equipment involved in this case was not as subject to technological obsolescence as was mainframe computer equipment and that the list price of such equipment tended to reflect the technological obsolescence that may have existed at the time of the sale. See also *Mukerji v. Commissioner*, 87 T.C. 926, 943 (1986).

The equipment was already delivered, installed, and on lease with Duquesne Light under the existing end-user lease agreement, circumstances often justifying, as they do in this case, a lease premium in the valuation of the equipment. *Mukerji v. Commissioner, supra* at 965.

The equipment has been maintained and upgraded under the maintenance agreement with ITT. The equipment has been released to Duquesne Light at the maximum lease renewal rates allowed under the lease renewal provisions and it remains on lease through the time of trial.

Petitioner's first expert witness began his valuation of the equipment with the nondiscounted list price of the peripheral computer equipment of ITT that is involved in this case and discounted that figure 10 percent for the unavailability of the investment tax credit. He factored into his valuation a 15-percent lease premium in light of the end-user lease with Duquesne Light, a 10-percent premium in light of the maintenance agreement, and a 5-percent

premium in light of the insurance carried on the equipment by Duquesne Light.

Petitioner's second expert witness based his valuation largely on a report he authored in 1981 under contract with the U.S. Government. That report evaluated and projected the future of the computer and data processing industry, and it projected future costs in 1990 and 1995 of specific types of computer equipment including terminal display equipment. The conclusions set forth in petitioner's second expert's 1981 report and his report prepared for this case generally support a finding that the ITT peripheral computer equipment purchased by petitioner and Moffatt for $300,000 was purchased at or below its fair market value.

Respondent's expert witness began his valuation with pricing information relating to IBM and Telex peripheral computer equipment that was only generally compatible with the ITT equipment involved in this case and which information was not available until after petitioner and Moffatt entered into the transactions in issue. Respondent's expert discounted the sales price that ITT charged Equitable by 20 percent for the unavailability of the investment tax credits. Respondent's expert offered no explanation as to why the discount would be 20 percent, twice the amount of the credit. Respondent's expert did not factor in any premiums for the existing end-user lease, for the maintenance agreement, for the insurance on the equipment carried by Duquesne Light, nor did he take into account the fact that the price Equitable paid ITT reflected a quantity discount not available to petitioner or Moffatt individually. Respondent's expert also ignored the fact that ITT increased the price of its peripheral computer equipment in November of 1981. Lastly, respondent's expert did not properly account for the differences between the ITT terminal displays involved in this case and IBM terminal displays (particularly the redundancy feature of the ITT equipment).

We summarize generally the opinions of Petitioner's first expert witness, but we use a 5-percent factor for the lease premium, and of respondent's expert witness as follows:

	Petitioner's 1st Expert	*Respondent's Expert*
List Price	$300,000	$278,775
Less Discount For:		
No ITC	10%	20%
Plus Premiums For:		
Existing Lease	5%	0%
Maintenance	10%	0%
Insurance	5%	0%
Fair Market Value:		
August 31, 1982	$329,870	$225,411
1982 Estimate of Residual Value in 1992	33%	–0–
1982 Estimate of Useful Life	14-16 yrs	4-6 yrs

We agree generally with the analysis and estimates utilized by petitioner's experts, and adopt the figures in the above summary reflecting the opinion generally of petitioner's first expert witness.

With regard to whether petitioner had an actual and honest profit objective for entering into the transactions in issue, many of the above factors are relevant. Additionally, we note that beginning in 1985, the fixed lease payments to be paid by Equitable to petitioner exceed the note payments due by petitioner to Cooper Leasing. Also, petitioner had the expectation that he would share in significant additional rentals on release of the equipment and that the equipment would have a significant residual value that would be realized on a resale of equipment. The fair market purchase price paid for the equipment, the features of the equipment, the existing lease with Duquesne Light, the historical performance of the equipment, and the subsequent renewal of the lease by Duquesne Light, among other things, establish and corroborate petitioner's profit objective.

We hold that the transaction before us in this case was not a sham transaction lacking in economic substance and that petitioner had an actual and honest profit objective for entering into the transaction.

Other Issues

Based primarily on the arguments he made concerning the issue of sham transaction and profit objective, respondent argues that petitioner and Moffatt did not acquire the benefits and burdens of ownership of the computer equipment, and that the underlying debt obligations were not genuine and therefore that interest actually paid on the debt obligations should not be deductible. Essentially for the same reasons we ruled in favor of petitioner on the sham transaction and the profit objective issues, we conclude that petitioner and Moffat acquired ownership of the computer equipment and that the interest actually paid by petitioner on his written debt obligations associated with this transaction is deductible in the year paid. See *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985), revg. on this issue 81 T.C. 184 (1983); *Rose v. Commissioner*, 88 T.C. 386, 423-424 (1987), affd., 868 F.2d 851 (6th Cir. 1989).

Respondent contends that additions to tax under section 6661 should be imposed because there was no substantial authority supporting the claimed treatment of the disallowed items. Sec. 6661(b)(2)(B)(i) and (ii). Petitioner argues that he had substantial authority for the deductions taken.

In this case, resolution of the only substantive issue decided against petitioner (namely, the at-risk issue) is based primarily on a conclusion drawn from very complex and interrelated contractual documents. *Epstein v. Commissioner*, T.C. Memo. 1991-252. The underlying facts of this case are somewhat similar to the facts of a number of other published opinions of this Court in which equipment leasing transactions have been found to be valid investments. See, among others, *Levy v. Commissioner*, 91 T.C. 838 (1988); *Gefen v. Commissioner*, 87 T.C. 1471 (1986); *Pearlstein v. Commissioner*, T.C. Memo. 1989-621. With regard to the at-risk issue, we cannot say that petitioner did not have substantial authority. See *Levy v. Commissioner, supra; Gefen v. Commissioner, supra; Emershaw v. Commissioner*, T.C. Memo. 1990-246, on appeal (6th Cir., Sept. 21, 1990); *Rubin v. Commissioner*, T.C. Memo. 1989-484; *Moser v. Commissioner*, T.C. Memo. 1989-142, affd., 914 F.2d 1040 (8th Cir. 1990); *B & A Distributing Co. v. Commissioner*, T.C. Memo. 1988-589.

On the facts of this case, we conclude that petitioner had substantial authority for claiming the deductions relating to his participation in the equipment leasing transaction and that the addition to tax under section 6661 should not be imposed.

Section 6621(c) provides for an increased rate of interest for substantial underpayments attributable to tax-motivated transactions. A substantial underpayment is an underpayment in excess of $1,000. Among the types of transactions considered to be tax motivated are losses disallowed as a result of the limitations of section 465(a).

We have previously determined that petitioner's losses are limited by section 465(a). Petitioner is therefore liable for increased interest under section 6621(c).

Decision will be entered under Rule 155.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Docket No. 92-4023
Filed Oct. 21, 1992

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the 21st day of October, one thousand nine hundred and ninety-two.

Present: HON. GEORGE C. PRATT, HON. J. DANIEL MAHONEY, HON. JOSEPH M. MCLAUGHLIN, *Circuit Judges.*

JOHN J. WATERS and JEANNE M. WATERS,
Petitioners-Appellants,

—v.—

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Appeal from the United States Tax Court.

This cause came on to be heard on the transcript of record from the United States Tax Court, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged and decreed that the judgment of said Tax Court be and it hereby is affirmed in accordance with the opinion of this Court with costs to be taxed against the appellants.

ELAINE B. GOLDSMITH, *Clerk*

By: /s/ EDWARD J. GUARDARO,
Edward J. Guardaro
Staff Attorney